



September 20, 2012

Statement for the Record, submitted by email

Joint Hearing on Tax Reform and the Treatment of Capital Gains

House Committee on Ways & Means and Senate Committee on Finance

Dear Chairman Camp, Chairman Baucus, and Members of the Committees:

On behalf of the Small Business Investor Alliance, the trade association representing private equity firms investing in domestic small business, thank you for holding a joint hearing on the tax treatment of capital gains in the context of comprehensive tax reform.

As you consider the impact of changing the capital gains rate, we urge you to take great care in rewriting the tax rules that could so fundamentally change the way capital is invested. The capital gains rate is a critical factor for small business investors. Policies encouraging small business investment are essential to a robust economy, but poor policy will be a job killer. For private equity funds that invest in domestic small businesses, the capital gains rate is not an ideological concept or academic exercise. It is very real tax that affects their ability to invest. Higher capital gains rates discourage investment in all businesses – including in small businesses. On the other hand, a lower rate on capital gains increases the amount of capital available that is so crucial for growing businesses and creating jobs.

Scale Matters for Small Private Equity Firms

Clearly the tax code needs massive reform. It is too complex, burdensome, and moves investment decisions from decisions based on the underlying business and economics to decisions based on tax implications. Investors want to spend their time and money investing and growing businesses, not spending time on how to survive in spite of the tax code.

Too often the national policy discussions on taxes are about the overwhelmingly big, aggregate numbers. There is inadequate discussion of how changes in policy will affect small business investing. *Scale matters* for private equity firms and Congress must specifically consider the policy implications on small business investing and not let job creators get overlooked in the complexities of multibillion dollar

multinational corporate tax policy. Small businesses employ half of the workforce and small firms accounted for 67 percent of the net new jobs since the latest recession, from mid-2009 to 2011.¹

It is a fact that the larger the entity, the harder it is for that entity to invest in small business. For example, a \$10 billion dollar fund simply cannot deploy its capital in sizes that small businesses can absorb. It is simply impractical to make 10,000 \$1 million dollar investments. Private equity and venture funds must put their money to work to make money for their investors. A \$10 billion dollar fund must deploy capital in sizes larger than \$50 or \$100 million. How many small businesses can absorb that type of investment?

The smaller the fund the more likely that fund is to invest in small business because it deploys capital in sizes they can absorb. It is nearly impossible for small private equity funds to invest in large publicly traded companies. There is nothing wrong with large funds investing in big businesses, investment of all types is good, but there are very big differences caused by scale that must be factored into any new tax policy.

To see how small funds and large funds could be impacted very differently by changes in capital gains rates take a look at who provides the capital to the funds. Private equity firms pool capital from several funding sources. These sources include institutional investors (i.e. pension funds) as well as individual investors. Pension funds do not pay capital gains taxes, but individuals do pay them. Larger private equity funds are much more likely to pool their funding from institutional investors and not from individual investors (pension funds are often too big to deploy capital to most small funds). However, smaller private equity fund have a higher percentage of investors as individuals – many small funds are entirely funded by individuals. Any tax measure which hinders individual investors will disproportionately and negatively affect small business investment.

Higher Tax on Capital Gains Discourages Small Business Investment

The economy needs jobs. Jobs are created when individuals and firms take risks by investing their capital in emerging enterprises and expanding businesses. Investors work hard to understand risk, spending months or even years getting to know a potential business. They put their capital to work seeking returns commensurate with the risk they are taking. The economy needs and thrives on business risk. However, political risk is completely alien to the investing equation. The uncertainty in the tax code leads many investors turning to Washington, turning to lobbyists, turning to political analysts before they invest. Congress needs to remove this political risk and provide certainty that there will be a long term, pro-investment, pro-growth, and pro-small business investment tax policy.

At the end of 2012, small business investors will not only face a tax hike on ordinary income rates, but on investment income as well. If Congress does not take action, the maximum statutory capital gains rate will return to 20% and the scheduled “Pease limitation” on itemized deductions will impose an additional 0.9% marginal rate on capital gains. In addition, Section 1411 of the Patient Protection and Affordable Care Act (PPACA), effective on January 1, 2013, imposes a new payroll tax on “investment income” which includes capital gains. This tax provision – which also applies to dividends, rents, and royalties – is a new 3.8% Medicare tax on investment income for couples earning more than \$250,000

¹ Bureau of Labor Statistics: www.bls.gov/bdm

(\$200,000 for single filers). Combining this new 3.8% Medicare surtax with the end of the year expiration of the statutory capital gains rates will mean that the top marginal capital gains rate will increase from 15% to 24.7%. This means that small business investors will be paying a staggering 66% increase above what they are paying today. This does not encourage investment in small businesses.

The potential impact of an increase in the capital gains rate to 24.7% will be harmful to the economy. A study by the Institute for Research on the Economics of Taxation shows the effect of the capital gains tax rate on economic activity and total tax revenue. The study looks at the impact on certain macroeconomic data if the top capital gains rate is increased from 15% to 24%. According to the results of the study, this capital gains rate increase from 15% to 24% would impact the following macroeconomic measures: Gross Domestic Product would fall by 2.4%; private business capital stock would decrease by 6.8%; and wages would fall by 2.2%.² Even CBO stated that real GDP will be 3.9% less in 2013 if we hit the fiscal cliff.³ Granted this CBO estimate factored both taxes and sequestration, but sequestration is another avoidable political risk being thrust upon a struggling economy.

Historically, capital gains tax increases point not only to reductions in revenues to the Treasury but also to reductions in the ability of private equity firms to attract new commitments. According to IRS data on revenue generated from capital gains taxes, the amount of revenues brought into the Treasury from capital gains is inversely related to the top capital gains rate. During the four year period before the Tax Reform Act of 1986 was enacted (Tax Years 1983-1986), when the top capital gains rate was 20%, the Treasury brought in an average of \$11.7 billion in capital gains tax revenues. Conversely, during the four year period after the Tax Reform Act of 1986 (Tax Years 1987-1990), when the top capital gains rate bounced as high as 28%, the Treasury brought in an average of \$8.1 billion in capital gains tax revenues. There is a clear difference between the revenue generated from a higher tax on capital gains versus a lower tax.

The increase in the top capital gains rate to 28% from 20% starting in 1987 may have negatively impacted new commitments to private equity firms. During the mid-1980s, new commitments to private equity partnerships trickled up each year from around \$2 billion in 1984 to over \$14 billion by 1987. However, new commitments to private equity declined by 27% the following year (1988) and were cut by 67% by 1990. Commitments slowly recovered back to the 1987 level by 1997⁴, almost ten years after the top capital gains rate was increased from 20% to 28%.

Permanently Make Capital Gains Rates Low to Remove Tax Uncertainty

Tax uncertainty, especially in recent years, is a major problem for private equity firms that invest in domestic small businesses. Because higher future capital gains rates ultimately and disproportionately affect small business investors return on their investment, uncertainty about these rates can prevent firms from making the best long term investment decisions. In addition, many small investment funds may struggle with the decision to unload their long term gains on capital assets in 2012 to prevent a

² Stephen Entin, *The Effect of the Capital Gains Tax Rate on Economic Activity and Total Tax Revenue*, The Institute for Research on the Economics of Taxation. October 9, 2009 <http://iret.org/pub/CapitalGains-1.pdf>

³ Congressional Budget Office, *Economic Effects of Reducing the Fiscal Restraint that is Scheduled to Occur in 2013*. May 22, 2013. <http://cbo.gov/publication/43262>

⁴ Stephen N. Kaplan, Private Equity Analyst, *Commitments to Private Equity Partnerships*. University of Chicago Booth School of Business.

severe tax increase on these investments next year. If the fiscal cliff encourages companies to unload these long term investments in order to avoid paying higher taxes, this may have a problematic outcome for long term business investments. The sale of investments should be based on efficient business decisions not tax avoidance strategies.

Small business investing is very sensitive to changes in capital gains rates, more so than investments in other types of business. Private equity investing involves the pooling of capital from multiple sources, often 10 or more years, and then investing from this capital pool. Without certainty in the long term capital gains rate, it will be more difficult for small private equity funds to acquire funds from new and established investor sources. Potential investors will seek other places to put their money because higher capital gains rates will reduce their return on investment in small private equity funds.

In order to foster the most efficient business environment, Congress needs to permanently keep capital gains rates low, particularly for small business investment. A more predictable tax code provides for a more favorable business environment, and low capital gains taxes will encourage outside investors to get involved as well.

Carried Interest Should Not Be Taxed as Ordinary Income

The debate over the treatment of carried interest is a painful example of tax policy discussions that are devoid of an analysis on the impacts to small business investing. Punitive proposals to increase taxes on private equity funds by changing the treatment of carried interest (from capital gains to ordinary income) will damage the ability of small funds to continue investing in small business. Carried interest is equal to 20% of the fund's profit on investment returns, and small funds rely on this performance-based revenue to make their operations sustainable.

Small private equity funds, who invest most of their funds in small business, are much more likely to have a performance-based revenue structure because they aren't large enough to be sustainable with a fee-based structure. Almost 90% of a small business investor's performance-based compensation comes from the carried interest after 10 years of successfully growing small businesses – and this is only if the fund has exceeded performance goals established over 10 years prior to the housing bubble, the tech bubble, or any myriad of macroeconomic shifts that were completely beyond the control of the fund managers.

It is certain that if carried interest is taxed as ordinary income the impact on small fund managers would be much greater and painful than for large funds. Changing the treatment of carried interest would cause small funds to change their revenue structure from performance-based revenue and towards a fee-based revenue structure. Thus, the consequence of this tax increase would be that smaller funds would force an end to their performance-based structure or grow larger and change to a fee-based structure. It is critical that smaller funds retain performance-based structures such as carried interest. This structure aligns interests of fund managers and investors and creates more opportunity for success.

As Congress rewrites the tax code, it is imperative that small investors are able to keep performance-based compensation structures like the carried interest model so that they are encouraged to make long term investments in small business. Decoupling performance from profit runs counter to good public policy and to common sense. If Congress wants to create jobs and it must recognize the impact that a

tax increase on the carried interest will have on small business investors and the businesses that they grow.

Conclusion

A healthy economy needs the entire investing spectrum to be healthy – from venture through buyout, both large and small funds. There are many lessons learned from the last time Congress enacted a tax overhaul package, and we encourage you to make important changes to the tax code that do not penalize investment.. A tax code that favors investing will have an important impact on the ability of small businesses to attract capital and create jobs.

Thank you for holding this joint hearing on tax reform and the tax treatment of capital gains, and we look forward to working with you to provide a favorable environment for the small business investor community.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance